

INTELLECTUAL AMMUNITION

Can Anybody Here Play This Game?

Thursday, April 4, 2002

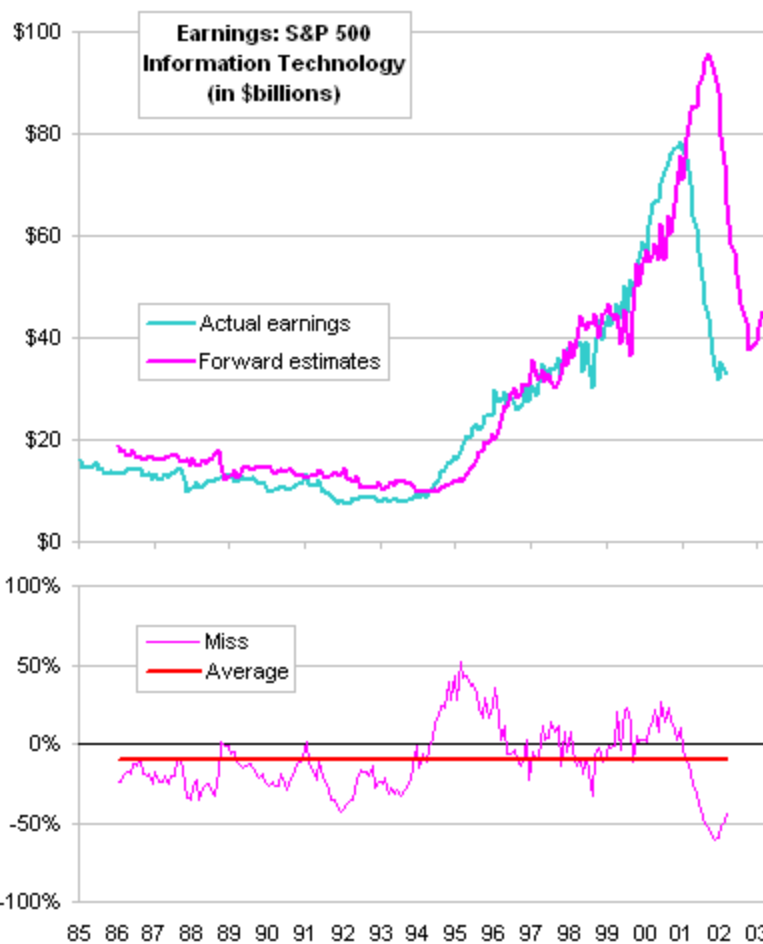
Donald Luskin

A smart Trend Macrolytics client asked me on [TrendMacro Live!](#), our real-time interactive commentary feature, whether it really makes sense to use consensus analyst forecasts in our "yield gap" model -- considering the terrible track record of most Wall Street analysts.

As he put it:

Casey Stengel must love this market. Don, regarding your fascinating piece yesterday "[Tech Hits the Wall](#)" -- most intriguing to me was the chart showing S&P 500 Information Technology sector earnings, and the two curves of actual earnings and forward estimates. If one should short anything it should be the analysts who missed the Jan 02 numbers by 60 billion! If that isn't the biggest miss in analyst history it has to be close. With all due respect to the yield gap model, there is plenty of reason to be suspect about the analyst/extrapolators that provide the

input for the consensus numbers. Perhaps the divergence from the yield gap is a healthy disrespect for the analysts' latest "guesses".



This is a trenchant critique, and I have a lot of respect for it. To respond to it, let's take a look at the chart again, but go all the way back to 1985.

Over history, actual earnings have come in 10.4% on average below the forward estimates made for them a year earlier -- this shows that, as you might expect, typically analysts are an optimistic bunch. But as our client suggests, we have just seen the biggest "miss" in the history of these statistics, with earnings for the year ended November 2001 coming in 60.9% below forecasts, or \$57.4 billion.

The only error of similar *percentage* magnitude occurred in the year ending February 1995, when the normally

optimistic analysts *underestimated* earnings by 50.3%. Of course, in terms of total dollar value, that pales in comparison with the more recent miss -- it was only \$5.3 billion (but way back then, that was real money).

Certainly there is every reason to believe that the analysts will continue to be wrong to some extent. But for the consensus implied in stock prices to be *right* at this juncture would require the analysts to be far more wrong than they've ever been before -- even more wrong than last year.

For actual earnings to surprise on the upside sufficiently to return today's yield gap back to the historical average, they'd have to come in at \$80.7 billion, which would be a miss of 79.0% over the estimate of \$45.1 billion -- a new record miss. To return today's yield gap just to the point of being only one standard deviation from its historical average would require earnings of \$56.5 billion, a miss of 25.3%. That's not a new record, but you can see on the chart how few times that has happened on the upside (while 25% downside misses are quite common).

What this means to me is that the yield gap analysis is -- at this time of extreme negative readings -- robust to even major errors in this critical input. This is emblematic of any analysis that relies on capturing temporary deviations from historical norms: they are most effective when they are most extreme (and perhaps they should be ignored altogether when they are not).

But there's another factor that our client should consider. While the analyst consensus will almost certainly be wrong to some extent, the yield gap analysis pits it against another consensus whose track record is hardly any better -- stock prices themselves.

The yield gap reached its all-time extreme negative reading in January 2000 at 4.5%, (compared to today's still pretty extreme reading of 2.9%). At that time the analyst consensus was calling for tech sector earnings of \$71 billion, and it's *that* consensus that led to the following year's disastrous downside miss. But at the same time, the fact that the yield gap then was more negative than it is today means that *the consensus built into stock prices was even more wrong than the analyst consensus*.

While the analysts were forecasting \$71 billion in earnings, stock prices then were implying \$184 billion in forward earnings! That's the value that would have been required at that time to return the yield gap to its long term average. You might not have thought it was possible, but stock prices were such miserable predictors that they managed to make the analysts look good by comparison -- even in history's worst year for the analysts.

The yield gap tool is all about catching the market in an internal contradiction. It compares stock prices, forward earnings estimates and bond yields -- each one a consensus unto itself, and each one a member of the larger consensus that is the market. When the three stray too far from each other, it's only a matter of time before they will eventually re-unify: in the end there can only be one market, existing in only one reality. So when these three consensuses (*consensi?*) disagree extremely, that's the sweet sound of opportunity knocking. **TM**